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INSIGHTS FROM THE BDO FINANCIAL SERVICES PRACTICE

DEMYSTIFYING VALUATION METHODOLOGIES:

PART 3 – DISCOUNTS FOR LACK OF MARKETABILITY (DLOM)

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OVERVIEW

As a follow-up to our valuation methodology piece on Multiples Analysis, this insight will address discounts for lack of marketability (DLOM). While we touch on a few very general approaches that are commonly used to derive the DLOM, the intent of this piece is not to promote any specific mathematical model. Rather, it is to create general awareness amongst CFOs and their counterparts to the necessity of accounting for the lack of marketability when using public company-based valuation models. In addition, judgement can play a large role in the DLOM calculation and its application. Therefore, the consideration of "best practices" can play just as important a role as the actual application of the DLOM.

This insight will outline a few methods commonly used to quantify the DLOM, as well as some of the challenges and best practices for fund CFOs to consider when applying the DLOM to valuations of privately-held investments.

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DLOM CALCULATION CHALLENGES

Investors who rely on public comparable company valuation analysis as a basis for private company valuations face many challenges. For example, private company investments typically lack access to capital markets, do not operate in a liquid market and may be subject to restrictions that constrain the transaction of the underlying equity. These restrictions make private company investments less liquid than public company equivalents and may necessitate the application of a DLOM adjustment in private company valuations to quantify the lack of liquidity.

In addition, estimating the appropriate DLOM to apply to private company valuations can be cumbersome. Deploying the wrong DLOM methodology may result in significant differences in fair value. Inconsistent application and failure to provide substantive support can also result in increased scrutiny from auditors and other constituents, leading to late-season discussions and delayed issuance of audited financial statements.

One of the main challenges for fund CFOs is choosing the appropriate approach in quantifying and supporting a DLOM adjustment. There are many variations and approaches in practice, and even the major accounting and valuation firms differ in their preferred approach.

The following section presents approaches that are generally applied and accepted in calculating the DLOM.

APPROACHES TO CALCULATING DLOM

Restricted stock studies

CFOs and valuation practitioners have often relied on empirical data studies, such as averages of various restricted stock studies, as a general guide to determine DLOM. Specifically, private placements of equity from publicly traded companies provide indications of DLOM through discounted transaction prices, as the market for these private placements (and subsequent restrictions pertaining to liquidating these privately placed securities via Rule 144) tends to be lower in contrast to the unrestricted public prices of the same companies. These discounts from empirical studies can vary anywhere from 5% to 50%. Therefore, practitioners have opted to take averages of these studies when considering the appropriate discount.

Pre-IPO studies

Various analytics and valuation firms have attempted to measure the sales prices of pre-IPO stock compared to the IPO price of the same company. Since the SEC requires all companies to report transactions of closely held stock and equivalents within a three-year period of going public, some practitioners have found it useful to leverage studies performed on data of pre-IPO companies that have subsequently gone public. While restricted stock studies rely on the private placement or transaction of stock in publicly traded companies, the pre-IPO studies tend to make a more direct comparison of the same company's privately held stock to its public share counterpart.

Selecting a discount through both the restricted stock studies and pre-IPO studies requires qualitative consideration to determine the appropriate discount. Those qualitative factors are referred to in many cases as the "Mandelbaum factors."

Put-based option models

Several mathematical models have been created utilizing different forms of put option calculations, the Chaffe model being just one example. Each approach has its advantages and disadvantages. The theory behind these calculations is that when a put option is purchased, it effectively provides the right to sell the underlying asset, so the value of the put results in the appropriate DLOM. The two primary inputs are the expected holding period and expected volatility, the latter of which may be estimated through the use of a representative publicly traded security. However, there are pitfalls in attempting to use an option pricing model (OPM) in calculating the value of a put option to calculate the DLOM. For example, as volatility in public markets increase, the risk of holding a private security may increase substantially, inferring a steepening of the DLOM.

While the OPM approach may provide a consistent and repeatable approach to calculating an implied DLOM, private fund CFOs may lack the time and ability to closely monitor these changes in volatility and accurately consider the appropriate holding period of an underlying private company position. Therefore, it may prove impractical to make continuous changes to a private company's discount in the eyes of the auditor and other constituents.

PRACTICAL CONSIDERATIONS FOR CFOS

While each of these approaches to calculating a DLOM has its strengths and weaknesses, it is equally important for CFOs to keep in mind the use and context of DLOM as it relates to discussions with auditors and other constituents. The following practical parameters and best practices can preclude unintended consequences when reviewing private company valuations that have DLOMs.

Update your valuation policy

When considering how to approach the DLOM, a good starting point for any CFO is their valuation policy. Since the steepness and application of a DLOM can be viewed as a pendulum based on an underlying company's financial condition and lifecycle/time to exit, the CFO should regularly monitor and update their valuation policy to ensure that all scenarios are considered and preferred DLOM methods are clearly outlined. The rationale for each level of discount should also be included, and the valuation policy should provide a "reasonable" level of flexibility to accommodate various underlying portfolio company scenarios.

Take a consistent approach

DLOMs can change, but we recommend consistency in your approach and application. There is no one correct approach to calculating and applying an appropriate DLOM. In this regard, we suggest attempting to select an approach or combination of approaches that can be used repeatedly and can be defended and easily explained to an auditor.

Avoid subjectivity

The sporadic application of a wide-ranging DLOM year-over-year to a private company investment can trigger lengthy discussions with, and questions from, your auditor and other constituents. That's especially true if changes are made to arrive at an intended fair value. Be consistent in your application of the position you have taken. Create some flexibility in your valuation policy, if needed, to allow for any changes in the underlying company's financial position. If you find yourself continually adjusting a company's fair value with the DLOM, revisit the valuation methodology you are using. It could be the case that the model or inputs you are employing are flawed and you are relying too heavily on the DLOM as a plug, thus leading to a more subjective application.

Review the private company's condition

There are plenty of scenarios in which a declining DLOM is warranted. For example, if an underlying private company is more closely mirroring its public counterparts through acceleration of financial success and the private company approaches a condition where an IPO is feasible, then the DLOM should rationally decline over time. In contrast, if a subject company's financial position were to worsen significantly (making it less appealing to a private company investor), the CFO should equally weigh this scenario.

Consider the private company's capital structure

The level of a DLOM applied to a private company valuation may vary based on the capital structure of a portfolio company. For instance, common stock or profits interest may be less marketable than the preferred stock in a private company with a complex capital structure. Therefore, a higher DLOM may be applicable to the common stock than the preferred stock.

Consider the valuation approach

Depending on the valuation approach employed, a DLOM may not be applicable or may need to be adjusted. For example, if a company has recently raised capital, and that capital raise is used to imply a value of the company, there may be some marketability already built into the private company valuation. Additionally, if a private company is being valued using expected exit values, marketability may already be considered in that value.

In summary, CFOs should utilize a DLOM most appropriate to private company investments based on specific facts and circumstances. However, given the imprecise nature of the DLOM calculation itself and the wide-ranging application of a DLOM, judgement should play a central role in its use as there is often not just one right answer. In fact, an approach or combination of approaches to applying a DLOM may be appropriate. It is important that, given the changing nature of a private company investment, all scenarios are clearly outlined in one's valuation policy and can be defended, if questioned. Furthermore, subjectivity should be minimized or avoided through a consistent application, and consideration should be given to the investment's current state.

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